

General Information Letter: Proceeds from settlement of lawsuits for infringement of intellectual property rights in materials used in training seminars are business income and should be included in the sales factor as provided in IITA Section 304(a)(3)(B-1) and (B-2).

September 12, 2000

Dear:

This is in response to your letter dated July 27, 2000, in which you request a letter ruling. I apologize for the delay in responding to you. The nature of your request and the information you have provided require that we respond with a General Information Letter, which is designed to provide general information, is not a statement of Department policy and is not binding on the Department. See 86 Ill. Adm. Code 1200.120(b) and (c), which may be found on the Department's web site at www.revenue.state.il.us.

In your letter you have stated the following:

xxx (xxx) is headquartered in xxxxxxxxx, California and is in the Management Training and Education business. xxx authors, copyrights and trademarks, books and manuals and assessment tools that are used in our Management Training Seminars as well as sold to the general public. Our customers are small and large companies that hire us to conduct Management Training Seminars at their locations in their state or country. We have discovered that there are organizations and individuals who are "using" our intellectual property without our consent. The usual manner of settlement is a lump sum payment to xxx for past use of our intellectual property and a contract for future use of our material either by the purchase of product or a licensing agreement is signed or a reprint right is sold.

We are writing to you for clarification on how to handle the taxation on the lump sum payment for the past use of our intellectual property. These payments are either settlements in lieu of formal lawsuit or they are as a result of a lawsuit.

Response

Under Section 203(b) of the Illinois Income Tax Act (the "IITA"; 35 ILCS 5/101 *et seq.*), a corporation begins the computation of its net income subject to Illinois income taxation by using its federal taxable income, and making specified modifications. No modification relates to the lump sum income you are inquiring about, and so any amount of settlement income included in federal taxable income during a taxable year will also be included in base income under Section 203(b) of the IITA; that is, in income prior to allocation and apportionment.

Under Article 3 of the IITA, a corporation must determine whether an item of income is business income or nonbusiness income in order to determine the extent to which that item of income is allocated to, and therefore taxed by, Illinois. Section 1501(a)(1) of the IITA defines "business income" to mean:

income arising from transactions and activity in the regular course of the taxpayer's trade or business, net of the deductions allocable thereto, and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations.

Section 1501(a) of the IITA defines "nonbusiness income" to mean "all income other than business income or compensation."

86 Ill. Admin. Code Section 100.3010(a) provides that "income is business income unless clearly classifiable as nonbusiness income." In the case of *Polaroid Corp. v. Offerman*, 349 N.C. 290, 507 S.E.2d 284 (1998), the North Carolina Supreme Court held that proceeds received from a patent infringement suit brought with respect to patents used by the taxpayer in its everyday business constituted business income. In reaching its conclusion, the North Carolina Supreme Court cited the analysis of the "business income" definition in *Texaco-Cities Service Pipeline Co. v. McGaw*, 182 Ill. 2d 262 (1998). Accordingly, income you derive from disputes over infringement of intellectual property rights used in your business will also be business income.

With respect to apportionment of business income under the IITA, for taxable years ending prior to December 31, 2000, most corporations use a version of the three-factor (payroll, property and sales) formula contained in the Uniform Division of Income for Tax Purposes Act. See Section 304(a) of the IITA. The weighting given to each of the factors has varied in recent years. See Section 304(h) of the IITA. For taxable years ending on or after December 31, 2000, only the sales factor is used to apportion business income. See Section 304(h) of the IITA.

For purposes of computing the sales factor, Section 304(a)(3) of the IITA provides, in part:

- (B-1) Patents, copyrights, trademarks, and similar items of intangible personal property.
 - (i) Gross receipts from the licensing, sale, or other disposition of a patent, copyright, trademark, or similar item of intangible personal property are in this State to the extent the item is utilized in this State during the year the gross receipts are included in gross income.
 - (ii) Place of utilization.
 - (I) A patent is utilized in a state to the extent that it is employed in production, fabrication, manufacturing, or other processing in the state or to the extent that a patented product is produced in the state. If a patent is utilized in more than one state, the extent to which it is utilized in any one state shall be a fraction equal to the gross receipts of the licensee or purchaser from sales or leases of items produced, fabricated, manufactured, or processed within that state using the patent and of patented items produced within that state, divided by the total of such gross receipts for all states in which the patent is utilized.

- (II) A copyright is utilized in a state to the extent that printing or other publication originates in the state. If a copyright is utilized in more than one state, the extent to which it is utilized in any one state shall be a fraction equal to the gross receipts from sales or licenses of materials printed or published in that state divided by the total of such gross receipts for all states in which the copyright is utilized.
 - (III) Trademarks and other items of intangible personal property governed by this paragraph (B-1) are utilized in the state in which the commercial domicile of the licensee or purchaser is located.
 - (iii) If the state of utilization of an item of property governed by this paragraph (B-1) cannot be determined from the taxpayer's books and records or from the books and records of any person related to the taxpayer within the meaning of Section 267(b) of the Internal Revenue Code, 26 U.S.C. 267, the gross receipts attributable to that item shall be excluded from both the numerator and the denominator of the sales factor.
- (B-2) Gross receipts from the license, sale, or other disposition of patents, copyrights, trademarks, and similar items of intangible personal property may be included in the numerator or denominator of the sales factor only if gross receipts from licenses, sales, or other disposition of such items comprise more than 50% of the taxpayer's total gross receipts included in gross income during the tax year and during each of the 2 immediately preceding tax years; provided that, when a taxpayer is a member of a unitary business group, such determination shall be made on the basis of the gross receipts of the entire unitary business group.

Section 304(a)(3)(E) of the IITA provides:

Paragraphs (B-1) and (B-2) shall apply to tax years ending on or after December 31, 1999, provided that a taxpayer may elect to apply the provisions of these paragraphs to prior tax years. Such election shall be made in the form and manner prescribed by the Department, shall be irrevocable, and shall apply to all tax years; provided that, if a taxpayer's Illinois income tax liability for any tax year, as assessed under Section 903 prior to January 1, 1999, was computed in a manner contrary to the provisions of paragraphs (B-1) or (B-2), no refund shall be payable to the taxpayer for that tax year to the extent such refund is the result of applying the provisions of paragraph (B-1) or (B-2) retroactively. In the case of a unitary business group, such election shall apply to all members of such group for every tax year such group is in existence, but shall not apply to any taxpayer for any period during which that taxpayer is not a member of such group.

Your letter does not contain any information that would allow me to provide guidance on how Section 304(a)(3)(B-1) or (B-2) would apply to your situation. If you have any questions concerning these provisions, please do not hesitate to ask.

In summary, the settlement amounts you receive will be included in base income in a particular year to the same extent they are included in federal taxable income in that year, and will be apportioned as business income. Section 304(a)(3)(B-1) and (B-2) of the IITA provide the rules governing the treatment of the settlement amounts for purposes of computing the sales factor.

As stated above, this is a general information letter which does not constitute a statement of policy that applies, interprets or prescribes the tax laws, and it is not binding on the Department. If you are not under audit and you wish to obtain a binding Private Letter Ruling regarding your factual situation, please submit all of the information set out in items 1 through 8 of the enclosed copy of Section 1200.110(b). If you have any further questions, you may contact me at (217) 782-7055.

Sincerely,

Paul S. Caselton
Deputy Chief Counsel -- Income Tax